No. 10,246

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

SAN JOAQUIN VALLEY POULTRY PRODUCERS ASSOCIATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONER.

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO

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I.

STATEMENT OF JURISDICTION.

This is a petition to review a decision of the United States Board of Tax Appeals. The petitioner filed its income tax returns, showing it to have no net income for the years 1936 and 1937, with the Collector of Internal Revenue for the Northern District of California (R. p. 20). The Commissioner of Internal Revenue gave notice of a deficiency for each of those years (R. p. 10). Petitioner filed a petition for redetermination of the deficiency with the United States Board of Tax Appeals (R. p. 3). On June 19, 1942, the Board of Tax Appeals entered a decision affirming

the determination of the Commissioner and finding a deficiency in petitioner's income tax for the years 1936 and 1937 in the respective amounts of $2261.01 and $2047.48 (R. p. 33). A petition for review of this decision by the United States Circuit Court of Appeals for the Ninth Circuit was filed with the Board of Tax Appeals on August 13, 1942 (R. pp. 33, 40). Jurisdiction of this Circuit Court of Appeals is founded upon Sections 1141 and 1142 of the Internal Revenue Code of the United States.

II.

STATEMENT OF THE CASE PRESENTING THE QUESTIONS INVOLVED AND THE MANNER IN WHICH THEY HAVE ARISEN.

Petitioner is a non profit agricultural cooperative association organized under the non profit agricultural cooperative act of the State of California. It has no capital stock and its members are all poultry producers. It markets the poultry products of its members and also functions for them as a purchasing cooperative, supplying them with farm supplies principally poultry feed. In the years in question, 1936 and 1937, petitioner marketed eggs for its members and handled the eggs in weekly egg pools. It would return to the members the proceeds of sales, less the necessary marketing expenses on the basis of the quantity of eggs delivered by them. It handled in those years an almost negligible amount of eggs for non member producers, i e., 1.77% in 1936 and .11%

in 1937 (R. p. 78). Non members received the cash value of their eggs on delivery (R. p. 52).

In both of these years petitioner operated as a purchasing cooperative and sold supplies to its members at cost plus an overcharge estimated to cover necessary operating expenses (R. pp. 53, 54). In its supply department activities petitioner dealt with non member producers in a small way. In 1936 this non member business represented 10.47% of the total business and in 1937 it represented .52% of the total business (R. p. 78). Non members were paid patronage dividends as were the members (R. p. 135).

At the end of the year the actual costs of operation were calculated. The excess, if any, in the overcharges collected, was then prorated to the patrons, both members and non members in proportion to their patronage. The policy of the association had been established and set forth in resolutions of the Board of Directors so that patronage dividends were to be paid to members and non members alike.

The non members received their patronage dividend in cash. The members received their patronage dividend partially in cash and partially as credits and interests in certain funds established under the by-laws or by resolutions of the Board of Directors. The interest of the members in these funds was evidenced by certificates issued or a statement of credit given to individual members.

When producers joined the association, they were advised that it was the policy of the association to

retain a certain portion of these overcharges, which belonged to the members, as "RETAINS" and that such retains would be credited to them in the reserves in which they might be placed so that their individual interest would be evident for future distribution (R. p. 146). This method of retaining a portion of the overcharges belonging to the members was adopted to build up working capital. The money was retained in place of being paid over to the member and then having him return it for use in that fund. He received the same credit therefor. This was carried out under a plan whereby the amounts retained from members would revolve so that as sufficient sums accumulated in a fund to carry on the operations of the association, the amounts first retained would be paid out to those to whom the retains belonged (R. p. 75). The Board of Directors determined the time when this payment was to be made (R. pp. 72, 75).

Petitioner operated a plant in Porterville consisting of a feed mill, warehouse and sales rooms. It maintained several revolving funds in its operations. Specific amounts were appropriated for each fund from the refunds due members at the end of the year and these amounts were apportioned to the individual members in proportion to their patronage.

In 1936 a part of the overcharges determined to exist at the end of the year was retained in a fund designated as "Reserve for Zoning Hazard", which was designed to provide capital to take care of possible costs of moving the plant (R. p. 62). The individual member was credited with the specific amount that

had been retained from him for this fund and that would have otherwise been paid to him and this credit was set up on his individual ledger account in the books (R. p. 63). In addition a statement was sent him showing the amount of his credit so retained. This was done by resolution adopted by the Board of Directors. In 1936 likewise a certain portion of the overcharges which had been determined to be due to members was retained and set up in a fund designated "Reserve for Security of Membership". This fund is provided for in the by-laws (R. p. 130) and was designed to build up the general working capital of the association. The amounts placed in that fund were specifically credited to each member and he was notified thereof. Also in 1936 out of the proceeds of marketing eggs which belonged to the members, an amount was retained which was placed in a fund designated as a "Reserve against loss by overpayment for eggs". Each member producer was credited with his respective interest in this fund and it was recognized as his property (R. pp. 68-69).

In the year 1937 there was retained from the overcharges belonging to the members a portion that was placed in the reserve for Zoning Hazard and also a portion was retained and placed in the reserve for Security of Membership. In each of these instances the individual member was credited with the respective amount that would otherwise have been paid to him, the credit was set up on his ledger sheet and he was notified of that fact. All of these credits were

given after resolutions of the Board of Directors authorizing the same.

The Commissioner of Internal Revenue refused to allow the amounts so retained in these particular funds as deductions from gross income or to recognize that these amounts did not constitute net income of the petitioner. He therefore assessed a deficiency tax against petitioner in each of the years 1936 and 1937.

Petitioner filed its petition with the United States Board of Tax Appeals for a re-determination of the deficiency so assessed. The action of the Commissioner was affirmed by the Board of Tax Appeals on the ground, as it stated, that these amounts were not subject to the members' "sole command" because as it contended they could not be withdrawn at any time by the members on their demand.

The Board of Tax Appeals in making its decision failed to give recognition to the fact that the amounts retained belonged to the individual members or to the fact that a definite liability existed in favor of each member as to the respective amounts credited to him. It failed to recognize that there had been a definite appropriation of the money to the individual member and that the retention of that money was with the consent of the individual member.

Under the statutes by virtue of which petitioner is organized and under its by-laws, these monies necessarily belonged to the individual member and became his property in proportion to his patronage. When the rights of the members in these overcharges

had been declared and the respective amounts had been credited, they then accrued as obligations of the petitioner to its members as patrons. These amounts did not inure to the benefit of the petitioner or to its members as members. It was not necessary that these amounts be paid in order that their nature as obligations of petitioner be established or in order that petitioner be permitted to deduct the same from gross income. This appeal involves the question as to whether a non profit cooperative organization can so build up its working capital by contributions from its members made out of refunds otherwise payable to such members.

In its opinion and decision, the Board of Tax Appeals did not apply the law as previously set forth in decisions of the United States Circuit Courts of Appeals and other decisions of the United States Board of Tax Appeals, which decisions recognize that if the right to receive this excess arises from statute or the by-laws or by action of the Board of Directors, a liability exists which is not taxable and that amounts retained under such circumstances do not constitute net income of the association. The test used by the Board of Tax Appeals ignores the rights of members in these overcharges and refuses recognition to an indebtedness that exists.

Although it was conceded that petitioner was a cooperative association carrying on business on a non profit basis (R. p. 29) and it appeared that although it did business with non members in a small degree, such non member business was also on a non profit

basis, yet the Board of Tax Appeals failed to recognize petitioner as a non profit agricultural association entitled to establish reserves and exempt from income tax under the terms of the Income Tax Act of 1936.

As petitioner had no net income for those years and also as it was entitled to set up reserves, this appeal is taken from the decision of the Board of Tax Appeals that there are deficiencies in income tax of the petitioner for the years 1936 and 1937.

III.

SPECIFICATIONS OF ERRORS RELIED UPON IN SUPPORT OF THE APPEAL.

The contentions of petitioner are set forth in the following specifications of errors as to the acts and omissions of the Board of Tax Appeals:

(1) The failure to allow as a deduction from petitioner's gross income in 1936 the sum of $1683.56 which was deducted and placed in a reserve for loss by over-payment for eggs.

(2) The failure to allow as a deduction from petitioner's gross income in 1936 the sum of $5722.72 which was deducted and placed in a reserve for zoning hazard.

(3) The failure to allow as a deduction from petitioner's gross income in 1936 the sum of $2215.29 which was deducted and placed in a reserve for security of membership.

(4) The failure to allow as a deduction from petitioner's gross income in 1937 the sum of $5358.46 which was deducted and placed in a reserve for zoning hazard.

(5) The failure to allow as a deduction from petitioner's gross income in 1937 the sum of $2601.90 which was deducted and placed in a reserve for security of membership.

(6) The failure to find that the deductions made for each of said reserve funds in the years 1936 and 1937 constituted an actual liability between petitioner and the individual producer members in proportion to their patronage and in the amounts respectively credited to each of said members in said reserve funds.

(7) The failure to find that the amounts credited in each of said reserve funds for the years 1936 and 1937 had been appropriated to the individual producers in proportion to their patronage and transferred to said funds as an addition to the working capital of the association with the assent of the said producers.

(8) The failure to find that the items disallowed were accrued as obligations of the association to the individual members.

(9) The failure to find that there was an existing liability of petitioner to each of the members in the specific amounts credited to each member in said reserve funds.

(10) The failure to find that the funds placed in these specific reserves in the respective years were credited to the individual members in proportion to their patronage and belonged to such members.

(11) The holding that there was required further corporate action by the Board of Directors of petitioner before the amounts placed in such funds belonged to said producers.

(12) The failure to find that the amounts placed in said funds constituted a liability of said petitioner to each of said producers and that the liability was created by the Board of Directors when the distribution to said funds was authorized.

(13) The failure to find that no further action of the Board of Directors was required for the purpose of creating said liability.

(14) The holding that the only deductions allowed would be limited to the amounts payable on the demand of the producers.

(15) The failure to find that the amounts placed in the (a) reserve against loss by over-payment for eggs in 1936, (b) the reserves for zoning hazard and security of membership in the years 1936 and 1937, respectively, did not constitute net income of the petitioner.

(16) The failure to find that petitioner was entitled to establish such reserves and place the respective amounts therein in the years 1936 and 1937 as a non-profit cooperative agricultural association.

(17) The failure to find that the reserves so established were reasonable reserves.

(18) The finding and holding that there were deficiencies in income tax for the calendar years of 1936 and 1937 in the respective amounts of $2261.01 and $2047.48 due from petitioner.

IV.

STATEMENT OF ARGUMENT.

The principal question before this court is whether those parts of the overcharges which had been credited and appropriated to the individual members in proportion to their patronage and as part of their patronage dividend and which were then retained by the petitioner in specific reserve funds constitute net income of the petitioner. It is the contention of petitioner that such amounts constitute a declared liability of the petitioner and are not taxable.

Petitioner is required to operate on a non profit basis both under the statute under which it is organized and under its own by-laws. These overcharges belonged to its members in proportion to their patronage. Its members permitted some amounts due them to remain with petitioner to be used as working capital but the retention of such amounts did not change the fact that these amounts belonged to the individual members and were not income of petitioner. They do not constitute net income. If included in gross income, petitioner was entitled to deduct such amounts from gross income.

Also, as petitioner is a non profit cooperative agricultural association engaged in marketing the agricultural products of its members and returning to them the proceeds less necessary marketing expenses and in turning over supplies and equipment at cost plus necessary expenses, it is entitled to establish reserves and the amounts placed in such reserves would not constitute net income.

A. THE STATUTE UNDER WHICH PETITIONER EXISTS AND THE BY-LAWS OF PETITIONER REQUIRE IT TO OPERATE ON A NON PROFIT BASIS SO THAT THE AMOUNTS INVOLVED BELONG TO THE MEMBER PRODUCERS AND ARE NOT NET INCOME OF THE PETITIONER.

Petitioner was organized under the Agricultural Non Profit Cooperative Marketing Association Act of the State of California (Now secs. 1191-1221 Agricultural Code of the State of California). Sec. 1192 of that code reads, "Associations organized hereunder shall be deemed 'non profit' inasmuch as they are not organized to make profit for themselves, as such, or for their members, as such, but only for their members as producers.

The Articles of Incorporation of petitioner provide that it shall be a non profit cooperative association (R. p. 93). The Articles further provide that "this association shall conduct and carry on its business without profit to itself, and shall not make, declare or pay to its members any dividend on membership certificates" (R. p. 95).

In Section 1, of Article VIII (R. p. 124) the by-laws carry on this recognition of its non profit nature and provide as follows:

"ARTICLE VIII.

Manner of Conducting Business
General Outline

Section 1. This Association is organized as a non-profit co-operative organization doing business with its members and with non-members as provided in the Articles of Incorporation of this Association.

The 'Net Proceeds' shall be such funds as are derived from Overcharges on sales and as are left after all expenses shall have been paid, or provided for, all at the discretion of the Directors.

The 'Net Proceeds' resulting from the operation of the business, if any, shall belong to the members and shall be known as 'Members' Purchase Credits' and shall be prorated to them in proportion to the amount of business each member has transacted with the Association during the period of time in which said 'Members' Purchase Credits' have accumulated."

The by-laws constitute a contract between the association and its members.

Riverside Land Company v. Jarvis, 174 Cal. 316, 163 Pacific 54, 59.

Under the provision set forth, the net proceeds, as so defined in the by-laws, become the property of the members and belong to the members whether paid to

them or retained by the petitioner for subsequent disposition. Since these funds belonged to the producers, they did not represent income of petitioner.

The courts of California have held that under this provision of the Agricultural Code, associations organized thereunder are not permitted to make profits for themselves and that withholdings representing funds similar to those involved in this proceeding belong to the producers. These decisions hold that the producers have a property interest in such funds even though they are retained by the association and paid out on a revolving fund basis.

Bogardus v. Santa Ana Walnut Growers Association, 41 Cal. App. (2d) 939, 947, 108 Pac. (2d) 52;

Loomis Fruit Growers Association v. California Fruit Exchange, 128 Cal. App. 265, 280, 16 Pacific (2d) 1040,

wherein the court states:

> "The Buford case need not be considered further than simply supporting what we have said, that the withholdings made by the Exchange were of moneys belonging to the Association and to the growers marketing fruit through the Exchange."

The Board of Directors recognized this legal and contract obligation when they provided for the credits to be given to the individual members as to any amounts retained by petitioner. They were set up as an accrued liability of petitioner to them and were not "income" of the petitioner.

B. THE AMOUNTS RETAINED BY PETITIONER AND PLACED IN THE RESPECTIVE FUNDS DID NOT CONSTITUTE NET INCOME OF PETITIONER AND WERE PROPER DEDUCTIONS FROM THE GROSS INCOME OF PETITIONER.

At the end of each of the respective years, the Board of Directors of petitioner determined the amount of overcharges available and adopted a series of resolutions so as to appropriate these sums for the individual producer in proportion to his patronage. This was in express recognition of the fact that they belonged to the producers and were not income of petitioner.

In 1936 the directors declared the express policy that patronage dividends would apply equally to members and non members alike (Ex. 3, R. p. 135). Then on December 31, 1936 the Board of Directors of petitioner adopted a series of resolutions setting up the patronage dividends and retaining a portion of the amounts belonging to members in the specific funds involved in this appeal (Ex. 4, 5, 6, and 7, R. pp. 136-139).

The resolution on patronage dividend provided that members would receive a patronage dividend of 2% of their purchases, plus the amount carried to the reserves for the account of the respective members. Non members received 3½% of their purchases, in cash, which was the equivalent of 2% and the amount carried to the reserves for members. The amounts so placed in these reserve funds were part of the patronage dividend of the members. These amounts were considered as patronage dividends and treated as such (R. p. 88). The resolutions as to patronage dividend and allocating the amounts to these reserve funds were

all adopted at the same meeting. When the amounts were so prorated they were immediately entered upon the books and credit was given to the individual producer in his account for the amount retained from his patronage dividends. Then a statement was sent to him showing such credit (R. p. 81). An exemplar of these statements is contained in the records (Ex. 13, R. p. 148). Also a statement was sent to him at the end of each year (Ex. 14, R. p. 150) showing his established interest in all funds.

In 1937 a generally similar set of resolutions was adopted (Ex. 8, 9, 10, 11, R. pp. 140-146). At the meeting of December 31, 1937 a series of resolutions provided for the patronage dividend and the disposal of the amounts determined as the interest of the respective members and non members therein. One resolution specifically reaffirmed the manner of handling amounts retained for these respective funds and reaffirmed the fact that they were an obligation of the association (Ex. 8, R. p. 148). The resolution as to patronage dividend provided for 2.87% of purchases by non members to be paid as a dividend and for a dividend of 2% of the purchases of members plus the amount carried to the reserves for the account of members. This equalized the patronage dividend between members and non members (Ex. 10, R. p. 144).

When a member entered this association he was advised of its policy in retaining a portion of the patronage dividend which would thus belong to him. He received a letter from the association in which, among other information, the following was contained:

"* * * Any difference between delivered prices and actual cost of goods, plus operating expenses, belongs to the members. At the end of each year such differences, in cooperative parlance called Retains, are pro-rated to members in proportion to their purchases as follows:

1st, each member's portion of all authorized reserves (set up for the protection of the business) is credited to him in his Members' Purchase Record and notice sent him periodically.

2nd, each member's portion of any dividends declared is given to him direct, 25% in cash and 75% in an interest bearing certificate. In the Members' Purchase Record a complete record is kept, not only of all of each member's purchases, but of his interest in all Retains, whether distributed in cash or certificates or whether retained for future distribution." (Ex. 12, R. p. 146.)

All of these acts on the part of petitioner and its Board of Directors constituted acknowledgment that the amounts concerned belonged to the individual members to whom they were specifically credited. The by-laws provided that they so belonged, the Board of Directors specifically appropriated these amounts to the individual members as their property and the authorized officers of the association set up the proper credits therefor. It is undisputed that the credits were set up and that the interest of the individual members in these funds was fixed on the books (R. p. 71).

These funds were set up to be operated on the revolving fund basis (R. p. 74). It was necessary to

accumulate money in this manner or the association would have had to borrow it from outside sources (R. p. 72). Securing it this way, the members themselves retained control of the financial structure of the association and the funds used as working capital. This, cooperative authorities regard as the most consistent and reliable source of capital revenue (see Evans & Stokdyk, The Law of Cooperative Marketing, pp. 164, 174). As the funds were built up, and at a time determined by the directors, they would start to revolve so that through deductions or retains from the later participation, the first contributions would be retired (R. p. 75). Thus the capital of the cooperative is maintained by those actually using it.

When the Board of Directors had acted in determining the amount of the overcharge and their action had been carried into effect by the placing of credits on the books in the name of the individual member, the liability of petitioner had definitely accrued and an indebtedness to the producer was created. Nothing further was required to be done by the Board of Directors to establish that liability. This indebtedness could not be classified as income and was not taxable.

> *Union Printing and Supply Company v. Commissioner of Internal Revenue,* 88 Fed. (2d) 75.

A case setting forth the principles under which this appeal should be determined is *Cooperative Power Plant v. Commissioner of Internal Revenue,* 42 B.T.A. 120, wherein overcharges for services had been purposely made to build up a fund to construct a new

power plant. The Board in determining that such overcharges were not income, recognized that gain was not an object of the cooperative arrangement and that this overcharge did not constitute gain for more than bookkeeping purposes. It held that the amounts represented indebtedness and therefore a liability and could not be taxed as income. Here also the overcharges represented an indebtedness and a liability to the individual producers. Gain was not an objective of this particular cooperative and there was no gain subject to taxation.

Likewise in *Valley Waste Disposal Company v. Commissioner of Internal Revenue,* 38 B.T.A. 452, 457, a similar ruling was made as to the funds collected which were not expended during the taxable year. The Board said:

> "Even though it might, for bookkeeping purposes be labeled 'surplus', it really represented an indebtedness to its members, or pay in advance for services to be rendered during a later year. It was, in no sense gains, profits, and income as such terms have been defined in Eisner v. Macomber, 252 U. S. 189, and kindred cases. At best it was a mere accumulation, paid in by the members, to be used for the purpose of disposing of the waste or to be returned to them upon dissolution. As was said by this Board in a case somewhat analogous—Growers Cold Storage Co., 17 B.T.A. 1279—the surplus overassessment 'was really an indebtedness or refund due the members and was a liability and not taxable'."

C. THE RETENTION BY PETITIONER OF A PORTION OF THE PATRONAGE DIVIDENDS WHICH HAD BEEN CREDITED TO THE INDIVIDUAL PRODUCER, AND THE USE OF THE SAME AS WORKING CAPITAL, DOES NOT MAKE IT A PART OF GROSS INCOME AND THEREFORE SUBJECT TO INCOME TAX.

The practice of petitioner in so treating and retaining the amounts due members at the end of a year is one common to many cooperative associations. They recognize that the overcharges on hand belong to the producers, they apportion the amounts to them but instead of making payment in cash, the amounts are reserved for working capital and the account of the individual member is specifically credited with his interest in the fund. The producers thereby build up slowly the necessary financial background for their cooperative. Tax authorities have recognized these practices of cooperatives designed to secure support from their own members and have held that these deferred payments were not income to the corporation.

S.M. 2288, C.B. III-2, p. 233, covered a cooperative that had set aside part of its savings in a reserve to finance its operation during the unremunerative part of the succeeding season. It was recognized that the amount so retained remained as a credit to the purchasers in proportion to their patronage and that payment was merely held in abeyance. It was ruled that this amount would not inure to the benefit of stockholders as such and would not affect its exemption from taxation. Again in S.M. 2286, C.B. III-2, p. 236, where part of the proceeds had been held with the consent of the growers to meet possible emergencies, it was recognized that the reserves would ultimately

revert to the growers to whom it essentially belonged and that such amount was not subject to tax as income.

In an office decision of the Income Tax Unit, this subject is discussed. In I.T. 3208, C.B. 1938-2, p. 127, an Iowa cooperative made additions to certain funds and credited the account of the members in proportion to business done with the association. Certificates were issued for these amounts which were handled on a revolving fund basis. In effect, the patrons took stock of the corporation in lieu of usual patronage dividends. In this decision, it is said:

> "This office is of the opinion that there is a distinction between the patronage dividends here involved and the payments ordinarily termed 'patronage dividends'. However, like ordinary patronage dividends, these in the present case do not represent gross income of the corporation. * * * As such credits represent contributions for capital stock, the amount thereof is not income to the corporation but the value thereof is income to the patrons credited. That is a patron member of one of the instant corporation agrees to buy or sell through the corporation with the understanding that in addition to the fixed consideration passing at the time of the transaction, his proportionate share of the proceeds of the corporation over its statutory operating expenses shall be credited to his capital account with the corporation."

Ours is a generally similar situation. Members, when they became such, knew that part of their share of net proceeds would be retained in authorized working capital funds and they would be credited therein with

their respective amounts. Owing to the fact that petitioner is a non-stock corporation, no stock was issued but the statement (Ex. 14, R. p. 150) sent out was more definite as to the interest of the member in such funds than any stock certificate might be.

In *Farmers Union Coop. Assn. v. Commissioner of Internal Revenue,* 13 B.T.A. 969, the cooperative provided for the issuance of stock in liquidation of credits credited to the accounts of its members as their proportion of the net overcharges determined at the end of the year. The Commissioner contended that this was a stock dividend; that it did not represent a liability to patrons; and that the amount in controversy was not paid. The Board of Tax Appeals held that under its by-laws which were a contract with its members, petitioner was liable to them for the full amount of its net operating income and that since the books showed the amounts distributable this was a liability at the close of the year. Therefore the Board held that this amount was erroneously included in taxable income. The Board also held that the issuance of stock was not a stock dividend as a distribution of corporate assets but was in discharge of a recognized liability of the petitioner. It therefore set aside the determination of the Commissioner as to a deficiency.

Under the by-laws of this petitioner, the amounts placed in the reserve funds in question represented a liability of petitioner to its members. Petitioner recognized that liability and set up on the books a credit to the individual member. This then was no part of taxable income. Certainly if the member had

been paid in cash and had then paid the sums into the association as working capital, that would not be income. Neither can the retention of the funds be regarded as the receipt of income. Surely the law would not compel a cooperative to go through this unnecessary expense of distribution and collection and will not penalize it by causing it to lose its right to deduct existing liabilities from gross income because it has not done so.

D. THE FACT THAT THE PATRONAGE DIVIDEND IS NOT PAID IN CASH DOES NOT AFFECT THE RIGHT OF PETITIONER TO EXCLUDE IT FROM GROSS INCOME.

The decided cases evidence the accepted rule that payment is not the test of deductibility and that nonpayment, where the liability is created by the by-laws or acts of the association and the credit to the individual appears, is completely immaterial.

Where we find, as here, that there has been a definite act of appropriation to the credit of the individual, then such amounts are deductible from gross income as an indebtedness has been created and they are no part of taxable income.

In *Anomosa Farmers Creamery Co. v. Commissioner of Internal Revenue,* 13 B.T.A. 907, petitioner, a creamery cooperative, determined its net operating income at the end of the year, prorated it and credited it to each patron in proportion to their deliveries. The Board held that this amount should not be included in gross income and that the fact that cash was not paid to the patrons in the taxable year was not material.

In *Home Builders Shipping Association v. Commissioner of Internal Revenue,* 8 B.T.A. 903, a further amount due stockholders had been determined but had not been paid. The Commissioner disallowed the amount because it had not been declared, accrued or paid and was eventually wiped out by operating losses. The Board stated "It is to our minds immaterial that the liability of $4137.70 has not, as yet, been paid." It held that there was an actual liability, set upon the balance sheet as being due to its stockholders and that therefore it should be treated as part of the cost of wheat sold. In the instant situation, petitioner had declared the amounts in question accrued and had set them up to the credit of the individual member. They appeared as a liability on the books of the corporation and the fact that they were not paid in cash would therefore be immaterial.

The Commissioner's office has acknowledged that the exempt status of a cooperative organization is not affected by the deferment of payment of patronage dividends to non members as long as the association keeps records thereof and sets up a specific credit to the individual account of each non member. (Mim. 3886, C.B. X-2 pp. 164, 166, I.T. 2791, XIII 1-77). Such amounts are not then regarded as income to the association. Surely then if members have been specifically credited with the amounts appropriated to them, such amounts cannot be taken as income of the petitioner.

E. THE FACT THAT THESE FUNDS ARE PLACED IN USE DOES NOT AFFECT OR CHANGE THEIR CHARACTER.

Respondent, before the Board of Tax Appeals, made the contention that because the monies in these funds were used by petitioner in its operation, it was not entitled to deduct the same from gross income. The use of these funds is no test as to whether the funds constitute taxable income.

The funds retained by petitioner are used in its operations. They may be used to supply equipment, finance marketing, purchase supplies or provide buildings and equipment. This is what they were intended for. However, the use of these funds does not change nor interfere with the existing liability or obligation to the member patron (R. p. 74). Once that obligation has been established, it remains as a liability until the member is paid.

The purpose for which the member permits the petitioner to retain his money is to furnish petitioner with working capital. This means that it will be employed in the operations of the association. It is not expected that it will be held in cash. However, at the time it is placed in these funds, it is the property of the member being turned into a working capital fund with his consent and approval. Later it will be revolved out and returned to him as other member patrons permit their funds to be retained and used for like purpose.

The fact that the sums so received by petitioner are subject to use by it does not make these funds income any more than the receipt by a corporation of the proceeds of stock sold to its stockholders is income be-

cause such monies are used for the purposes of the corporation. It is simply working capital which is no part of gross income and not subject to tax as income.

F. THE BOARD OF TAX APPEALS HAS FAILED TO APPLY CORRECTLY THE LAW APPLICABLE TO THESE FACTS AND HAS ATTEMPTED TO SET UP AN ERRONEOUS AND UNAUTHORIZED TEST BEFORE RECOGNIZING A PRESENT INDEBTEDNESS.

In its decision the Board of Tax Appeals has quoted three cases to support its finding. However the Board has failed to follow the language and reasoning of the cases and has disregarded the actual facts of this case.

In *Fruit Growers Supply Company v. Commissioner of Internal Revenue,* 21 B.T.A. 315, affirmed 56 Fed. (2d) 90 (C.C.A. 9), this court only took the position that until patronage dividends were declared they would not accrue as obligations. In that case there had been no deductions or declarations on the part of the Board of Directors or the corporation in reference to the overcharges. Here specific provision for credit was made by resolution of the Board of Directors, an entry was placed on the individual's ledger account and a statement sent to him, so that the liability definitely accrued.

In *Farmers Union Cooperative Company v. Commissioner of Internal Revenue,* 90 Fed. (2d) 488, no action had been taken by the company as to the balance held by it. The court ruled that the right of ownership of the individual producer would not accrue until a patronage dividend had been declared. It did

not require that it would have to be paid. That court recognized that its decision might have been different if, as with this petitioner, the articles or by-laws of the association concerned had contained provisions requiring such apportionment to members. The court said:

> "As stated above, if petitioner had been organized and operated on a purely co-operative basis where all annual net earnings were apportioned to all of the patrons during the year, there might be here a more serious question as to whether such earnings constituted 'income' within the Amendment." (492)

The Board also cited a recent decision of this Circuit Court, *Cooperative Oil Association v. Commissioner of Internal Revenue,* 115 Fed. (2d) 666, but made no comment on the same. An examination of that opinion shows that it does not apply to this appeal. In that case there was no provision in the articles or by-laws showing that the net proceeds belonged to members, nor was there any active appropriation of the amounts in question to the individual producer. No resolution was adopted by the Board of Directors as was done here, nor was any entry made on the records. Therefore the Board and this court held that lacking that appropriation, no liability had been created. No one of those cases support the ruling of the Board as to the facts of this proceeding.

The Board attempts to set up a new test of liability and to build their decision on two words used by the late Justice Holmes in *Corless v. Bowers,* 281 U. S. 376, 74 Law. Ed. 916 wherein he used the expression

"unfettered command". The Board endeavors to imply that only if the producer had the right to payment on demand could these amounts be recorded as a liability and therefore not income. Certainly such logic violates all reasoning. Liability can still exist whether an indebtedness is payable on demand, at a certain date in the future or even at a future date not yet certain. The obligation constitutes an indebtedness even though the money is not immediately payable.

Nelson v. Wilson, 264 Pac. 679, 683, 81 Mont. 560.

If the Board had followed the spirit of the decision of Judge Holmes in that case, it would have found for the petitioner. He there said, "Taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed—the actual benefit for which the tax is paid." Here the benefit that accrues is to the producer. He has acquired additional property by reason of his right to a proportionate interest in the overcharge. It either lessens the cost of his operation or gives him in the case of his marketing pools an additional amount of net proceeds. This involves his individual income and he is the beneficiary. It is his income that must be taxed. Information as to his gain is given to him in the form of an acknowledgment of the credit owing to him. It is upon his command and consent that the funds are used as working capital by the petitioner for the association is controlled by its producer members. Even following the language of Judge Holmes, the credits here involved were subject to the "unfet-

tered command" of the producers and did not constitute income of the petitioner. That command is not lost because the member assents to the retention of the amounts which are to be paid to him. The assent to such use upon his becoming a member is an exercise of that command.

The Board in a very recent case, also involving 1936 and 1937 income taxes, *Midland Cooperative Wholesale v. Commissioner of Internal Revenue,* 44 B.T.A. 824, held that the retention of amounts placed in reserves represented a liability of the association and that the amounts so placed in reserves were deductible from gross income. In that case, part of the patronage dividend was paid in cash and part was placed in an equity reserve account. Each patron was notified, as in this case, of the amount of his credit in that reserve account. There was no specific time at which he would be paid. The Commissioner refused to allow as deductions the amounts so credited which were left in the association as working capital. The Board in reversing this ruling, recognized that the undivided surplus belonged to the patrons and was required to be distributed to them annually on the basis of patronage. It recognized that these amounts were in reality rebates upon the business transacted by the association with its members rather than true income of the association. It also recognized that the association could set aside a portion of the amount in a reserve account since there was no prohibition of law against it. The Board then considered the question as to whether there was a liability to pay the members and said in that regard:

"The next question is whether additional corporate action is required to be taken before petitioner becomes under a definite liability to pay to its members the amounts set aside to their credit. Petitioner points out that the amounts to be paid forthwith to its members in cash and the amounts to be held in reserve were both authorized at the same time and by the adoption of one resolution; that both were allocated to the members at the same time and entered upon the corporate ledger as credits; and that both were computed upon the business transacted with the association. It argues, therefore, that both were properly accrued as liabilities upon its books. We agree with petitioner. In our opinion all necessary steps were taken in the taxable years to obligate petitioner to pay the earnings over to its members. The resolutions of the Board of Directors recognized that the entire amounts—$53,601 in 1936 and $58,673.43 in 1937—belonged to the members. The statutes and the by-laws so provide. If any other disposition of such earnings had been made—other than putting them in permanent surplus—the directors would have committed an unlawful act, which under the statutes of Minnesota would have been 'cause for the cancellation of the charter'. The amounts in question were not put in permanent surplus. They were allocated to the members, though held in reserve."

The facts of that case are practically on all fours with the facts of this proceeding. The amounts to be paid members and the amounts to be held in reserve by petitioner were both authorized at the same time and by the same series of resolutions. These amounts were

all set up in the ledgers as credits at the same time and both were proportionately computed upon the business transacted with petitioner. Also as in that case, no additonal action was required to create the liability and the producers would clearly be general creditors of petitioner if the association was liquidated before they were paid (By-laws, Art. IX, R. p. 133).

The Board has attempted to differentiate the *Midland* case by suggesting that the amounts so payable could have been withdrawn at any time. However the facts of the case as set forth in the Board's opinion, show no difference. In its statement of facts, page 830, the Board says:

> "At the time of the hearing most of the amounts which had been credited by petitioner to its members in connection with the patrons' equity reserve were still held by it. In 1939 one of its members was liquidated and 1940 one was placed in receivership. *In each instance request was made that petitioner apply the amount which had been credited to the member against its indebtedness to petitioner. This was done after approval by petitioner's board of directors.* In the first instance petitioner was thus enabled to collect $1.06 and in the second, $91.99. The remaining amounts credited to the members as shown above are still held by petitioner." (Italics ours.)

It must be noted that the application of these amounts against the indebtedness due from the member was only made after approval by the Board of Directors. The liability of the association to the pro-

ducer existed at all times as here, but in order to apply the credit, it was necessary that the Board of Directors of that association act.

Under the by-laws of this association, Article VIII, section 11 (R. p. 131), the association retains a lien against the interest of the members for any indebtedness due the association and the credits held may be applied to reduce such indebtedness. Certainly if a member was liquidating or was in receivership, the Board of Directors of this petitioner would have authorized the application of credits due him against indebtedness due the association and thus have secured payment of such indebtedness. What Board of Directors would not so approve under such circumstances? There is no distinction between the cases and this petitioner is entitled, on the basis of the *Midland Cooperative Wholesale* case, to have the decision of the Board of Tax Appeals reversed.

The Board of Tax Appeals has, by its opinion in this case, narrowed and restricted the exemption which Congress gave to these cooperative marketing associations. Congress has consistently fostered and encouraged cooperatives since the enactment of the Clayton Act in 1914 (15 U.S.C., Sec. 17).

> *Liberty Warehouse Company v. Burley Tobacco Growers Associaton,* 276 U. S. 71, 93, 72 Law. Ed. 473, 481.

From the early days of the Federal Income Tax, it has been recognized that true cooperatives such as petitioner have no net income and they have been accorded exemption from such tax (1916 Income Tax

Law, Sec. 11, 39 Stat. L. 771). The Treasury Department gave to these acts the liberal construction intended by Congress. This intent was well known and has been recognized by the Board of Tax Appeals itself.

> *Eugene Fruit Growers Association v. Commissioner of Internal Revenue,* 37 B.T.A. 993, 1003.

In *Farmers Co-operative Creamery v. Commissioner of Internal Revenue,* 21 B.T.A. 265, 267, the Board in discussing the effect of the Revenue Act of 1926, wherein Congress first provided by statutory legislation for reserves for cooperatives and for their right to do business with non members, said:

> "That this action by Congress did not change the existing law but was designed solely to prevent a possible narrowing thereof by administrative construction fully appears in the Conference Report of the Congressional Committee at page 37, wherein it is stated: '* * * This amendment does not broaden the scope nor even include all of the provisions of the Treasury regulations, but only incorporates certain provisions adopted by the department as fundamental in allowing exemptions to cooperative marketing and purchasing associations. The amendment assures such associations, now exempt, that the liberal construction by the department of existing law is sanctioned by Congress, and will prevent a restriction upon the present exemptions, such as is now possible under existing law.'
>
> "An almost identical statement appears in the report of the Committee on Finance of the Senate.

> "From the foregoing it is apparent that Congress looked with entire favor on the broad construction given to the Revenue Act of 1924 and that Regulations 65 truly reflected the Congressional intent."

The decision in this case tends to defeat that intent. It imposes a restriction never intended to be applied, one that would hamper and defeat the ability of cooperatives to build up their working capital by contributions from their own members. Taxing of this working capital so obtained, is completely contrary to the intent of Congress to prevent restrictions upon present exemptions.

G. PETITIONER, AS A NON-PROFIT COOPERATIVE AGRICULTURAL ASSOCIATION WAS ENTITLED TO BE CLASSIFIED AS AN EXEMPT CORPORATION AND WAS ENTITLED TO ESTABLISH REASONABLE RESERVES FOR ANY PURPOSE AND THE AMOUNTS PLACED IN THESE RESERVES IN 1936 AND 1937 DID NOT CONSTITUTE NET INCOME.

Section 101 (12) of the Revenue Act of 1936 (49 Stat. L. 1648) provided as to exempt corporations as follows:

> "(12) Farmers', fruit growers' or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of

members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses * * * nor shall exemption be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose. Such an association may market the products of non members in an amount the value of which does not exceed the value of the products marketed for members, and may purchase supplies and equipment for non members in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 per centum of the value of all its purchases. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this paragraph."

In the petition filed in this proceeding, petitioner specifically set forth that the Commissioner had failed to give recognition to the cooperative nature of this association (R. p. 7). This was one of the grounds relied on to show that the Commissioner erred in including as net income the amounts referred to in this proceeding.

The evidence clearly and conclusively establishes the non-profit cooperative nature of petitioner and its exempt status.

By its charter from the State of California as contained in its Articles of Incorporation (R. p. 92), petitioner is required to carry on its business without

profit to itself and cannot declare any dividends on membership certificates (R. p. 95). This it has carried out in its operations. It operated without profit to itself or to its members as such. It did business at cost for its producer patrons.

In marketing agricultural products for its members, it turned back to them the proceeds less necessary selling expenses. In providing them supplies, it did so on the basis of cost plus necessary expenses, equalizing the matter of expenses by refunds provided for at the end of the year, as is the recognized procedure of such associations.

Petitioner carried on some dealings with non members. These dealings were slight in 1936 and almost negligible in 1937, being much less than one per cent of the total business. However it paid patronage dividends to non members as it did to members. The directors recognized and directed that members and non members were to be treated alike (R. p. 135) and the record shows such equitable treatment to have been given (R. pp. 137, 143).

There can be no question as to the reasonableness of these reserves as to amount or purpose. In the first place, it must be the intent of the act that such question be first addressed to the discretion of the Board of Directors, the administrative body of a cooperative marketing association. Secondly, the evidence establishes the necessity and shows the amount of the particular reserve funds involved to be reasonable.

Petitioner's annual business amounted to close to $2,000,000 (R. p. 77) and the sums set aside for these

reserves can readily be seen to be reasonable for such a marketing and supply activity and to maintain its mill, warehouse and selling office.

The reserve for Zoning Hazard was necessary to provide capital that might be required for a possible sudden change in the location or set up of the association's plant (R. p. 62). The prospect of such need was imminent. It was not only a reasonable but a most prudent exercise of judgment to provide necessary working capital through a building fund so as to insure the uninterrupted operation of the activities of petitioner for the benefit of its producer members.

> *Eugene Fruit Growers Association v. Commissioner of Internal Revenue,* 37 B.T.A. 993, 998.

The amounts determined as reasonable and necessary by the Board of Directors constituted about one-third of one per cent of the business done.

The reserve against loss by overpayment for eggs was a caution taken by the Board of Directors in 1936 (R. p. 69). This was a reasonable precaution to provide funds to cover such a contingency and the amount of $1683.56 set up to protect an egg volume of $727,-979.01 was on its face reasonable.

The reserve for Security of Members is provided for in the by-laws (R. p. 130) and was intended and used to build up working capital to meet the expected growth of the association. Its purpose is essential and reasonable. Its amount (ten per cent of net overcharge, or about one-seventh of one per cent of business done) is clearly reasonable, considering the needs of the association, as is evident from the record.

Since this petitioner operated as a non-profit agricultural cooperative marketing and purchasing association, its right to accumulate and have these reserves is clearly acknowledged by the Income Tax Act. It should have been recognized as an exempt corporation with a clear right to set up or add to its reserves. That right is not defeated by the fact that it unequivocally recognizes the rights of its members to the sums placed in these reserves and that these sums belonged to them so as to create an obligation of the association towards them.

V.

CONCLUSION.

Petitioner respectfully submits that it had no net income in the years 1936 and 1937. The amounts set aside in these particular reserve funds represented an accrued liability of the petitioner to its members. These amounts belonged to the members and had been appropriated and specifically credited to each of them in proportion to their patronage. They did not constitute net income of the petitioner and should not have been so classified by the Commissioner or the Board of Tax Appeals. Further, petitioner was an exempt corporation and as such entitled to place these funds in its reserves.

It is respectfully submitted that the decision of the Board of Tax Appeals should be reversed.

Dated, San Francisco,
November 4, 1942.

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